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TAGS: [EFIN](#) [ECON](#) [ETRD](#) [PREL](#) [PINR](#) [RS](#)  
SUBJECT: KUDRIN ON RUSSIA'S RISING DEFENSE BUDGET AND  
CONTINUING FINANCIAL CRISIS

REF: A. MOSCOW 2800  
[1](#)B. MOSCOW 2804

Classified By: Ambassador John Beyrle, Reasons 1.4 (b/d).

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Summary  
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[1](#)1. (C) During a September 23 meeting with the Ambassador, Finance Minister Aleksey Kudrin said defense spending in 2009 would increase only slightly. He acknowledged that there was pressure for greater increases because of the current tensions, but said Russia did not want and could not win a new arms race; higher defense spending would destabilize the Russian economy. In a candid discussion of Russia's financial crisis, Kudrin explained that the increased liquidity the GOR had provided in recent weeks would not remedy the economy's main weaknesses: oil dependence and an underdeveloped financial system. He predicted that the banking sector would be hit hard by the crisis and said the GOR would not bail out every bank that was in trouble. Kudrin added that he valued consultations he had with senior Treasury officials this year as well as Secretary Paulson's frank assessment of the U.S. market's current distress. He said he was looking forward to seeing Paulson in Washington in October at the World Bank/IMF meetings. End Summary.

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Higher Defense Spending but Not Too High  
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[1](#)2. (C) In response to the Ambassador's question about whether the budget would be affected by defense or agriculture spending increases, Kudrin responded that federal expenditures would change very little from the planning reflected in the 2009-2011 budget that the GOR had approved and submitted to the Duma in late August (Ref A). Expenditures would remain steady as a percentage of GDP. He conceded, however, that defense spending would increase in the 2009 budget but said the increase would be "symbolic" and similar to the increase in the 2008 budget.

[1](#)3. (C) Kudrin indicated, however, that there was considerable pressure within the GOR to devote even more resources to defense spending. This was a consequence of the increased tensions with the U.S. over the Georgian conflict as well as disagreements over NATO expansion and missile defense. Russia did not want and could not win another arms race. Moreover, the Russian military would have difficulty absorbing a large increase in its budget and using the funds

effectively, and a big increase in its budget would be seen by Russia's neighbors as a threat. Kudrin admitted that higher defense spending could also have a destabilizing effect on the Russian economy. He expressed hope that U.S.-Russia tensions would subside, and thus pressure to raise defense spending would subside as well.

¶4. (C) Describing his comments as his "personal opinions" (but similar to what we've heard from other senior GOR officials), Kudrin said that expanding NATO to include Ukraine was both hasty and short-sighted. He suggested that MAP for Ukraine took no account of the historical ties between the two countries or the intricate web of personal, familial and professional relationships between Russians and Ukrainians that would be damaged. Kudrin accepted the Ambassador's statement that neither NATO nor NATO expansion posed a threat to Russia's security, but he maintained that Russian citizens would not see membership for Ukraine that way and neither would many Ukrainian citizens.

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Russia's Financial Woes: More on the Way  
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¶5. (C) In a candid assessment of Russia's financial crisis, Kudrin said GOR action to increase available liquidity during the last month had done little more than temporarily provide breathing room for banks to meet their short-term obligations. The main underlying problems were the country's dependence on oil and an underdeveloped financial system, both of which raised the risks in the Russian markets. He compared Russia to other emerging markets but said softening oil prices and the flight to quality had shown Russia to be

more sensitive than China or India to global trends. The banking sector's poor financial intermediation had also made the economy increasingly dependent on net capital inflows, and those in-flows were now declining.

¶6. (C) Kudrin said the effect of the crisis on Russia's banking sector would likely be severe. Banks have relied heavily on foreign capital for medium and long-term financing and declining access to that capital would put them under pressure. In addition, he pointed to the distress that had befallen KIT Finance and Svyaz Bank. Both banks had used their holdings of shares in Russian firms as collateral on the interbank loan market, and when share prices plummeted, both had defaulted on their obligations.

¶7. (C) As part of its efforts to keep the situation under control, Kudrin said that the GOR had orchestrated Leader Asset Management's takeover of KIT Finance (Ref B) and had also taken steps for state bank Vneshekonombank (VEB) to absorb Svyaz Bank. However, the GOR would not be able to facilitate the rescue of every distressed financial institution; those decisions would be made on a case-by-case basis. He speculated that many banks were having difficulties meeting their obligations and that the crisis would quicken the pace of the banking sector's consolidation as many small and medium-sized banks were closed or taken over by larger banks.

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Good Relationship with Treasury  
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¶8. (C) Kudrin said that he valued the opportunities that he had had, particularly in the last few months, to consult with Secretary Paulson and senior Treasury officials on the evolving financial crisis. He also expressed gratitude for the helpful discussions with Treasury on the margins of G8, G20, and APEC meetings and he expressed appreciation for the recent exchanges with Treasury about Russia's holdings of Fannie Mae and Freddie Mac bonds as well as Secretary Paulson's views on the turmoil currently affecting U.S. markets. He hoped that he and Secretary Paulson would have time to meet at the upcoming World Bank/IMF meetings and that there would be the usual G8 meeting among Finance Ministers

to discuss anti-money laundering, counter-terrorist financing, and assistance issues.

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Comment  
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19. (C) Kudrin was extremely candid, in line with his stated interest in keeping the lines to Treasury open as Russia wrestles with a financial crisis that he clearly worries is not yet under control. His reassurances that as Finance Minister he opposes large increases in defense spending -- and for that matter any increased spending in this time of economic uncertainty -- were consistent with his advocacy of budgetary discipline above all. However, nationalist pressures to increase military spending will test his ability to win the final argument on this. End Comment.  
BEYRLE